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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1975

No. 74-1508

ELOT H. RAFFETY FARMS, INC.,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
for the Eighth Circuit

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The Petitioner prays for a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Eighth Circuit entered in the above cause on February 26, 1975. Petitioner's Petition for Rehearing was overruled on *March 20, 1975.*

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit and the dissenting opinion of Gibson, Chief Judge, have not yet been reported. The opinion and the dissent appears on Page A-12 in the Appendix in this Brief.

The opinion of the District Court for the Eastern District of Missouri is reported at 369 Fed.Sup. 653, and appears at Page A-2 of the Appendix to this Brief.

JURISDICTION

The Judgment of the Court of Appeals for the Eighth Circuit was entered on February 26, 1975. Petitioner's Petition for Rehearing was overruled on March 20, 1975, a copy of the Judgment is set forth in the Appendix, Page A-25. The jurisdiction of this Court is invoked under 28 USC 1254(1).

QUESTIONS PRESENTED

1—Whether El Sombrero, created under Mexican law, was an association taxable as a corporation under Section 7701 (a)(3) IRC.

2—Whether El Sombrero was merely a passive dummy or nominee of the Missouri partnership.

STATUTES, FEDERAL RULES AND REGULATIONS INVOLVED

26 U.S.C. 7701(a)(3), which provides as follows:

> "Corporation.—The term 'corporation' includes associations, joint-stock companies, and insurance companies."

Internal Revenue Regulation 301.7701(2)(a) defines the characteristics of a corporation as follows:

> "(1) Associates; (2) Object to carry on business; (3) Continuity of life; (4) Centralization of management; (5) Limited liability and (6) Free transferability of interest."

Internal Revenue Regulation 301.7701-2(a)(2) provides that:

> "* * * characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. * * * On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.
>
> (3) An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited ability, and if the limited partnership has no other characteristics which are significant in determining its classification, such limited partnership is not classified as an association."

Internal Revenue Regulation 301.7701-2(b) provides that:

> "* * * if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist."

Internal Revenue Regulation 301.7701-2(c)(3) provides that:

"Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is no centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.

(4) There is no centralization of continuing exclusive authority to make management decisions, unless the managers have sole authority to make such decisions."

STATEMENT

This is an action for refund of income taxes arising out of a loss sustained by a Missouri partner in farming activities conducted in Mexico in 1966 and 1967. Because of hurricanes, excessive rains and insects, appellee, as its share of the partnership loss, lost $220,000.00.

Plaintiff is a Missouri corporation engaged in the farming business with its principal place of business in Mississippi County, Missouri. In 1965, plaintiff, with two other Missouri citizens entered into an oral partnership arrangement to conduct farming operations in Mexico. The services of a Mexican attorney, Mr. Gutierrez, were obtained to assist them in complying with Mexican law so the partnership could engage in the farming business (R. 13). Gutierrez advised that El Sombrero was like a limited partnership (R. 41).

The Missouri partners understood that El Sombrero was a limited partnership in Mexico (R. 14). It was their belief that the formation of this partnership was necessary in order to comply with some of the revolutionary tenets of the Mexican Government. No member of the Missouri partnership ever be-

came a subscriber or an assignee of the S. de R. L. nor was any interest ever transferred or conveyed to them. The Missouri partners were not acquainted with any of the organizers of the S. de R. L. nor could they speak Spanish and did not receive a translated copy of the S. de R. L., until the litigation arose (R. 13). Luis Vargas Nunez, the administrator designated in the Articles, never had anything to do with the management or control of El Sombrero. The $2 million in pesos cited in the Articles and the $500,000 pesos recited in the Articles were never contributed by the subscriber, Mr. Facundo and Mr. Villela. No member of the Missouri partnership ever advanced any money to the organizers of El Sombrero (R. 17). There were no meetings of El Sombrero, annual or special, no shares of stock were issued. When the Missouri partnership was organized in Missouri in the early part of 1965, it was not their intention to do business in the corporate form in Mexico (R. 18).

The Missouri partners intended to operate in Mexico as a limited partnership and had no personal knowledge of the legal requirements of Mexico concerning farming (R. 63). There was no conveyance or assignment of anyone's interest to El Sombrero; no stock was issued; and there were never any actual meetings in Mexico (R. 64). Luis Vargas Nunez did not handle the business of El Sombrero. There was no accounting or administration made annually and when the business was liquidated in the spring of 1968, it was not carried out by Mr. Nunez (R. 65). Nunez had nothing to do with the management of the farming business and the three Missouri partners had equal voice and control in the management of the partnership affairs. The Missouri partners did not intend or believe they were investing money in shares of a Mexican corporation and the first they knew of any claim that El Sombrero was a corporation was when the Internal Revenue Service conducted an examination of their tax return (R. 74-75). Rafferty had never even seen a translated copy of the Articles of El Sombrero until the Internal Revenue Service furnished him a translated copy (R. 75).

The District Court found the issues in favor of the taxpayer, stating (App., Page A-4):

> "The *El Sombrero S. de R.L.* was not organized for the purpose of avoid taxes. Rather, it was organized upon the advice of Mexican legal counsel to allow the Missouri partners to farm in Mexico without being in violation of Mexican law. However, the *S. de R.L.* performed no substantial business function. The organization was never capitalized nor managed according to the provisions of the organization articles. The farming operations were controlled by the Missouri partners and managed locally by Elott Raffety. When the farming business was liquidated in the Spring of 1968, the liquidation was not carried out by the nominal administrator, Nunez. There were no annual meetings or accountings ever held as required by the organization articles. The only apparent purpose of the organization was the use of its name by the farming operation. None of the Missouri partners were ever subscribers to the *S. de R.L.* articles, nor did they ever own any legal interest in the organization."

The Court of Appeals, in a two to one opinion reversed the Judgment, holding that El Sombrero was a viable business entity, with more corporate characteristics than noncorporate characteristics, and was engaged in substantial business transactions and could not be disregarded for tax purposes.

In the dissent, Chief Judge Gibson stated:

> "The majority's decision in this case is another application of an anomalous principle under which the taxpayer always loses. If the substance of the transaction favors the Government, we look to substance (which we should); if it favors the taxpayer, we ignore it and look to form. It is improper in this case to impute corporate characteristics where there were none so as to deny the claimed operating

> loss of what was obviously a partnership venture. Whenever taxation is allowed to depend upon form rather than substance, 'the door is opened wide to distortions of the tax laws.' *Landa v. Commissioners*, 211 F.2d 46, 50 (D.C. 1954). Here, as elsewhere, the decision should turn on substance regardless of the outcome. *Estate of Smith v. Commissioner*, 313 F. 2d 724, 730 (8th Cir. 1963).
>
> I believe the entity as it was actually formulated and used by the partners did not possess sufficient corporate characteristics, even viewed under the Treasury Regulations cited by the majority, to warrant limiting the taxpayer to capital loss deductions by labeling this nebulous entity a corporation. It was in reality no more than a sham. None of the Missouri partners subscribed to the Articles which created the entity; they couldn't even read the Spanish language of the Articles, and were not informed of their specific contents until the IRS provided them a translation. They were issued no stock, notes, assignments, or other conveyance evidencing their interests in the entity. Nor did they receive any assurance of dividends, interest, security or a fixed date for repayment of their advancements of operating funds.
>
> Moreover, none of the Mexican subscribers (fictional owners) made any actual investment in the partnership or Mexican entity and only one participated in its affairs. Indeed, they were practically unknown to the Missouri partners and no money was invested by the partners in their behalf. The figurehead administrator's activities appear to have been limited to signing documents with which he was unfamiliar or uninterested. He did not conduct the 1968 liquidation of the entity as the Articles purported to require. Nor were any required annual meetings conducted or accountings rendered. In sum, the entity was never capitalized or managed according to the provisions of its organizational Articles."

REASONS FOR GRANTING THE WRIT

The petition raises substantial and important questions concerning the administration of the Internal Revenue Laws relating to the tax consequences of foreign business operations conducted by United States citizens. The decision of the Court of Appeals, if permitted to stand, will adversely affect foreign business activities conducted by American citizens abroad. The business organization created in Mexico (Sociedad de Responsibilidad Limitada) is not recognized in the United States. This record is undisputed that the Missouri partners relied on the advice of Mexican Counsel that the S. de R.L. was a limited partnership. The Missouri partners could neither read, write nor understand Spanish and did not even see a copy of the Articles of S. de R.L. until this litigation commenced. It was the partners' understanding that it was simply a limited partnership. The Eighth Circuit in a narrow and strict construction of the Internal Revenue Code has upheld the claims of the IRS that the S. de R.L. was an association taxable as a corporation. Further, the decision of the Court of Appeals is contrary to the declared policy of Congress in permitting taxpayers to select whether they want to be taxed as a partnership or as a corporation when Congress enacted Legislation allowing small corporations to be taxed as partnerships.

Rabkin & Johnson, Federal Income Gift and Estate Taxation, Page 273(a), it is stated:

> "When Congress in 1958 introduced the election for close corporations to be taxed somewhat like partnerships (§ 2.14), the Treasury recognized that it was Congressional intent to allow taxpayers to choose the most convenient form of doing business, without the overwhelming consideration of a tax handicap. As a result, the Treasury in 1960 issued detailed regulations under the corporate definition statute which gave enough leeway to partnerships and syndicates to enable practically all of them to operate without risk of corporate taxation."

Thus it is seen that had the taxpayer intended to organize a corporation, and if, in fact, did organize a corporation, under legislation enacted by Congress it could be considered as a partnership and these losses fully deductible as operating losses. It is neither fair nor equitable for the Government to impute corporate characteristics to the S. de R.L., in order to defeat the substance of the transaction and the intentions of the partners. It is undisputed that a partnership arrangement was intended and not a corporate form. Since 1958, it has been the policy of Congress to let the taxpayers make such a choice and not the Internal Revenue Service.

The petition also presents the important question of whether in administering the tax laws of the United States, the Government will be allowed to look to the substance of the transaction, if it favors the Government, but if it favors the taxpayer, to ignore the substance and look to form. The even handed and impartial administration of the revenue laws of the United States requires the Government to look to the substance of the transaction whether it favors the taxpayer or not. Here, as pointed out in the dissenting opinion of Chief Judge Gibson, the El Sombrero was, "* * * in reality no more than a sham."